TESTIMONY OF ALEX KNOPP – MARCH 21, 2022
FINANCE, REVENUE AND BONDING COMMITTEE
IN SUPPORT OF SB 443 AAC THE TAX INCIDENCE REPORT, TAX INCIDENCE ANALYSIS AND THE DISCLOSURE OF RETURNS AND RETURN INFORMATION

TO THE CO-CHAIRS, RANKING MEMBERS AND DISTINGUISHED MEMBERS OF THE FINANCE, REVENUE AND BONDING COMMITTEE:

I had the privilege to serve in the General Assembly from 1987 to 2001 and was a House member of this Finance Committee for 14 years. I respect the hard work all of you invest in making our state better and appreciate the difficult fiscal choices you must make. May I please be permitted to give a special greeting to my longtime friend and former House colleague Sen. Fonfara. I collaborate now with other former elected officials and policy advocates on the Property Tax Reform Collaborative of the 1,000 Friends of Connecticut.

I last submitted testimony to the Finance Committee in 2017 in my role as an adjunct faculty member at Yale Law School co-teaching its clinical class on Legislative Advocacy. I urged this committee at that time to reinstate the practice of funding a regular Tax Incidence Study of Connecticut's revenue system which had not been done since 2014. You deserve congratulations on adding the funding and reinstating the legislative mandate last year that produced the new January 2022 Tax Incidence Study.

I support SB 443 because it would require the Connecticut Department of Revenue Services to issue a tax incidence analysis every two years. I also endorse the recommendations made in testimony today from John Filchak, the Executive Director of NECCOG, and from Patrick O'Brien of Connecticut Voices for Children.

I am testifying in writing today to request that you consider adding a new and different recommendation to the incidence factors listed in Sections 1 and 2 to include the incidence impact of any relevant "federal tax offset" in any future tax incidence analysis.

Analyzing the impact of the federal tax system on the incidence of the Connecticut revenue system is necessary and important because the Connecticut tax system does not exist in isolation. According to the Minnesota tax incidence study (see p. 6), which was cited many times during the March 11 public hearing of this committee on the Connecticut report, the "incidence" of a tax is determined not by who pays it in the first instance but by who bears the burden of the tax's final resting place after any tax shifting has occurred. The Connecticut report (at p. 7) similarly calls this the "Final Incidence" of any tax.

It has been at times a deliberate goal of Connecticut tax policy (such as adopting the statewide income tax in 1991) to shift as much as possible of the final state tax burden to the federal government. Tax-making policy in Connecticut has always been significantly influenced by attempting to maximize this federal transfer. Consider the many policy-related ways that the final incidence of these Connecticut state and local taxes that will be the subject of the next Connecticut Report could be impacted by the "**federal tax offset**":

- Connecticut state income taxes are deductible in calculating federal tax liability
- Connecticut homeowner local property taxes are deductible in calculating federal tax liability
- Connecticut business local property taxes are deductible in calculating federal tax liability
- Connecticut local car taxes are deductible in calculating federal tax liability
- Connecticut business local personal property taxes are deductible in calculating federal tax liability

In each of these cases, the households or businesses paying these Connecticut taxes who deduct them on their federal returns by itemizing their deductions will end up paying less in federal personal or business income taxes and thereby reduce their overall tax burden. By itemizing their state and local tax deductions (called the SALT deduction), these taxpayers will have successfully "shifted" part of the "final incidence" of these taxes to the federal government, thereby reducing their net or final state tax burden.

I believe that the next tax incidence analysis will be more accurate and useful in setting future tax policy if it takes into account this "transfer" policy of shifting a portion of the final incidence of the taxes listed above from Nutmeggers to Uncle Sam. I don't think you can accept as a meaningful "incidence assumption" in Sec. 2, line 47 of SB 443 that the federal tax offset should be completely ignored!

As further proof of the need to include a "**federal tax offset**" in the next report, let's also recall that one of the biggest changes in tax policy that occurred between the issuance of the 2014 and the 2022 Connecticut Tax Incidence reports was the imposition in 2017 of the $10,000 federal cap on SALT deductions imposed by the Trump Administration to target state governments in high-deductible Blue States like Connecticut, New York, and New Jersey.

This "once in a century" unprecedented Congressional tax transfer policy hit Connecticut very hard. More than almost any other state, tax filers in Connecticut heavily utilized the SALT deduction. According to a 2018 report by the Office of Legislative Research, Connecticut ranked second among the 50 states in the percentage of filers claiming the deduction -- 41 percent of state filers or 726,560 filers — compared to Maryland's highest at 46 percent, New Jersey at 41 percent, and Massachusetts at 37 percent.

Connecticut also ranked second among all states in the amount of the average SALT deduction claimed at $19,665 per filer, compared to New York's highest at $22,169, California at $18,437, New Jersey at $17,850, and Massachusetts at $15,571.

Shouldn't this dramatic reversal in incidence that partially shifted the tax burden from the federal government back to our state be reflected in any tax incidence reporting?

Perhaps some of this SALT burden-shifting was offset by the 2017 federal tax change increasing the size of the standard deduction, thereby reducing the number of Connecticut taxpayers who itemize their deductions. But that's exactly the type of incidence measuring that a tax study should be required to research and disclose—who pays and what is their burden?

By including a "**federal tax offset**" in the methodology required in the next Tax Incidence report as mandated by Section 1 of SB 443, Connecticut legislators and policy makers will have a much more accurate understanding of the impact of federal tax policy on the "final incidence" of our state and local taxes.

The Minnesota tax incidence study did not take into account a "**federal tax offset**," for the reasons it lists in the appendix I have attached to my testimony (below). But Connecticut is a very different state from Minnesota on tax policy given our high per capita income rank. The SALT cap hit our state much worse, as an example. Perhaps you could request OLR or OFA to research which of the other states that have undertaken tax incident studies have included some element of the federal tax offset so that you can review their reports as well.

Thank you for your consideration of this recommendation.

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TESTIMONY APPENDIX: Reprinted from the 2021 Minnesota Tax Incidence Report, Section B, pps. 62-3:

An Alternative Methodology: Adjusting for the Federal Tax Offset

In estimating the incidence of existing Minnesota taxes, this study has made no adjustment for the "federal tax offset" due to the deductibility of Minnesota taxes in calculating the federal income tax. Individuals can generally deduct what they pay in state income tax and homeowner property taxes (and a portion of their motor vehicle registration tax) as itemized deductions. Those who itemize deductions pay less federal income tax as a result. For a taxpayer in the 24 percent federal tax bracket, each additional dollar of itemized deductions lowers federal income tax by 24 cents. As a result, 24 percent of deductible state and local taxes would be borne by the federal government in lower tax revenue. If no adjustment is made for this federal tax offset, the Minnesota tax burden is arguably overstated. Because itemizing deductions is more common for higher income households (and because they face higher federal tax rates), the federal tax offset will reduce taxes by much more in the upper deciles. A tax system that looks proportional in the absence of such an adjustment might look quite regressive after such an adjustment is made. A regressive system would look even more regressive.

There is a strong argument, however, against making such an adjustment in this study. This study estimates the burden of Minnesota taxes in a multistate context. The incidence of Minnesota taxes depends on the level of taxes in other states. If all states levy deductible taxes, then the federal government presumably makes up for the lost revenue by raising federal tax rates. It is unlikely that the deductibility of state and local taxes actually lowers the total federal tax burden on Minnesota residents. Minnesota's share of itemized deductions is roughly equal to its share of federal income tax payments. Whether the combination of deductible taxes and higher tax rates reduces a particular decile's tax burden is unknown; it depends on how the federal tax structure has been adjusted to make up for the lost tax revenue.

The results presented elsewhere in this study include no adjustment for the federal tax offset. The impact of such an adjustment is shown only in this section.

The impact of the federal tax offset for non-business taxes is shown in *Tables 4-5* and *4-6*, and *Figure 4-2*. For all households combined, the federal offset for non-business taxes would reduce Minnesota tax burdens by 1.7 percent, reducing the effective tax rate from 12.0 percent to 11.8 percent of income. This effect is much smaller than in previous studies because of federal law changes enacted in December 2017, which increased the standard deduction and suspended some itemized deductions. As a result, fewer taxpayers itemized deductions on their federal returns, reducing the size of the federal offset. In 2016, 36 percent of income tax filers itemized deductions. In 2018, only 11 percent of filers itemized deductions. That percentage is expected to decline to 6 percent in 2023.

The federal offset makes no significant difference in the effective rate in the first three deciles, which include few who itemize deductions. There are measurable impacts beginning in the 4^{th} decile and rising with income. For the 10^{th} decile, the effective tax rate falls from 11.8 percent to 11.6 percent. For the top 1 percent, the effective rate falls from 11.5 percent to 11.4 percent. The adjusted tax burden for all state and local taxes is slightly more regressive, with the full-sample Suits index falling from -0.013 to -0.016. (In 2016, the impact was much more noticeable, reducing the overall Suits index from -0.026 to - 0.062.)

Given the small impact of the federal offset and the strong arguments to be made against such an adjustment in a study of this kind, no federal tax offset is included in the results presented elsewhere in this study.

As explained in *Section D* of this chapter, though, the federal tax offset *should* be included in estimates of the incidence of *changes* in Minnesota taxes.

(Charts omitted.)